2007/2008 : Report 7

OFFICE OF THE

Auditor General of British Columbia

Improving Financial Reporting for British Columbians:

Report on the 2006/07 Public Accounts

March 2008

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The Honourable Bill Barisoff
Speaker of the Legislative Assembly
Province of British Columbia
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Dear Sir:

I have the honour to transmit herewith to the Legislative Assembly of British Columbia my 2007/2008 Report 7: Improving Financial Reporting for British Columbians: Report on the 2006/07 Public Accounts.

John Doyle
Auditor General of British Columbia

Victoria, British Columbia
March 2008

copy: Mr. E. George MacMinn, Q.C.
Clerk of the Legislative Assembly

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Acknowledgements

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This report is based on the result of audit work done mainly between August 2006 and July 2007 by about 70 staff and contractors of the Office of the Auditor General of British Columbia, and by many private sector accounting firms that took part in the audit of the Summary Financial Statements and in audits of all government organizations that are included in the government reporting entity.

We received full cooperation in our audit from government's staff.

Auditor General's Comments

John Doyle
Auditor General

The audit opinion I provide for the Province's Summary Financial Statements is the primary output of my Office. All of the work my staff and others carry out in financial statement audits across the government reporting entity, as well as for central government, culminates in this overall opinion on government's consolidated financial statements.

A secondary output from the audit opinion is this report, where the key matters affecting the quality of government's financial reporting are laid out, as well as recommendations I believe will further improve their quality.

Looking ahead to the future of financial reporting and the role of my Office, several themes emerge. As my predecessors have mentioned, accounting and auditing standards have been changing. This will continue to be the case, with major changes coming from the adoption of international standards, which will significantly impact the look and the feel of financial reporting across the country—which will be a big challenge for the public sector based on my experience—and the amount of work required to issue an audit opinion. This has already occurred in many countries and is due in Canada over the next few years.

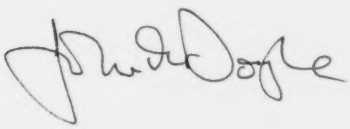
My Office will continue to move with the times and will proactively prepare for and discuss these changes with government which, like any significant change, will require extra work, time and commitment that will impact my audit office as well as staff within ministries and Crown agencies.

Looking ahead in my term as Auditor General, there are several focus areas related to the quality of financial reporting I intend to examine and report on. Governance processes and practices, as well as financial management and controls are important to review to ensure they are operating as intended. Legislators and the public have a right to know how well government is carrying out its stewardship role over the public's resources. I plan to have a higher profile for my Office in the government reporting entity and will carry out a number of assessments within organizations as well as cross sector work in areas such as governance, internal audit, and budgeting and forecasting.

Government also has a large number of IT systems in use or planned in the public sector. In many cases the effective utilization of these systems are integral to successful program outcomes. I intend to have a focus on a number of those systems, and in doing so, I will be increasing the resources devoted to this area.

As I discuss more fully in the report, coming to grips with an array of complex financial transactions government has entered into, such as private-public partnerships, has been an ongoing challenge. Given the increased popularity and long-term nature of these significant financial commitments, I intend to continue to keep a focus in this area, which will include several in-depth assessments.

In summary, I wish to thank all those in my Office and those inside and outside government who assisted in the audit of British Columbia's 2006/07 Summary Financial Statements.



John Doyle
Auditor General

Victoria, British Columbia
March 2008

Detailed Report

Key Points

The Public Accounts is the main publication used by government to report annually on its financial performance. The Auditor General provides an audit opinion on the Summary Financial Statements included in the Public Accounts. This is the most significant portion of work within the Office's mandate.

One of the by-products of our audit is this report, which we have produced for a number of years. Our aim is to comment on, and assist government in meeting its stated commitment to improving the quality of its financial reporting. We do this by noting the improvements it made from the year before, as well as by suggesting where changes would further enhance the quality of its financial reporting. We also make note of future changes in accounting standards that we believe will affect the Public Accounts.

All of the items we discuss in this report are significant enough to be brought to government's attention in the interests of improving the quality of its financial reporting. However there are 5 items in particular that we see as key ones affecting the quality of financial reporting, including two (treaty costs and resource roads) that need to be resolved in terms of accounting treatment and measurement. We are hopeful they can be resolved and will continue to monitor government's progress for possible implications on our 2007/08 audit of the Summary Financial Statements.

Summary of Key Points

Key Point	Page no.
Contractual obligations disclosure	15
Public-private partnership accounting	29
Resource roads accounting	30
Government transfers accounting	37
Treaty accommodation and settlement costs	41

Background

Introduction

As an independent Office of the Legislature, we report on, and provide recommendations to improve, government's financial management and accountability practices. Our annual audit of the Summary Financial Statements of the Province of British Columbia is a significant and ongoing focus of our Office because these statements are a major means by which government accounts for its financial performance.

The audited Summary Financial Statements are included in the Public Accounts published by government (and are also available online at www.fin.gov.bc.ca/ocg/pa/06_07/pa06_07.htm). The Public Accounts also includes unaudited information, such as management's discussion and analysis of the financial results, and information about the Consolidated Revenue Fund.

We conduct our audit to assess whether or not the statements present fairly both the financial position of the Province and the results of its operations, and we then report our findings to legislators and citizens of the province. And that is what we did, when we issued our audit opinion, which was published by government in July 2007 as part of its financial statements.

How do we know what are best practices?

Because many government transactions are complex, it is important that the accounting policies chosen to record and report them are the best ones for making the financial information understandable and conveying what actually happened. Accounting and reporting standards exist specifically for the public sector, but it often requires significant analysis and professional judgement to decide which are most appropriate for a given situation.

In Canada, accounting standards for governments are issued by the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA). Further guidance exists in the accounting standards issued by the Accounting Standards Board of the CICA for publicly traded and privately owned companies. These standards are referred to as Canadian generally accepted accounting principles (GAAP). In British Columbia, the Budget

Transparency and Accountability Act requires government to follow GAAP in the preparation of its Summary Financial Statements.

In situations not covered by Canadian GAAP, guidance on appropriate accounting policies can be obtained from standards issued by bodies empowered to do so in other jurisdictions.[1] However, when a Canadian jurisdiction looks to other sources of GAAP, it must be sure to choose policies that are consistent with this country's GAAP, including PSAB and its conceptual framework for accounting standards.

According to PSAB, the accounting policies chosen should result in financial statements that:

- provide an accounting of the full nature and extent of the financial affairs and resources that government controls, including those related to the activities of its agencies and enterprises;
- describe government's financial position in a way that is useful for evaluating government's ability to finance its activities, meet its liabilities and commitments, and provide future services;
- describe the changes in government's financial position, showing the sources, allocation and consumption of government's resources, how government's activities affected its net debt, and how government financed its activities; and
- demonstrate the accountability of government for the resources, obligations and financial affairs for which it is responsible.

Government is obligated to ensure that its financial statements properly present the operating results and financial position of the whole of government. Adopting best practices in financial accounting and reporting helps government fulfill this important responsibility effectively.

[1] Examples include the Government Accounting Standards Board and Financial Accounting Standards Board in the U.S., as well as the International Accounting Standards Board.

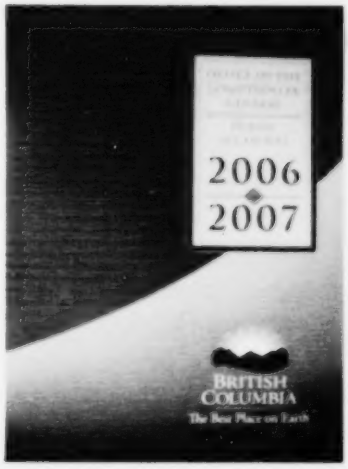
Improved Presentation and Other Accounting Changes

Each year, government steadily improves its presentation of the Public Accounts. As well, it makes changes to its accounting policies in response to new standards and to evolving organizational circumstances that require a different accounting treatment.

In this section, we discuss the most significant improvements and changes government made in last year's Public Accounts report, and we outline our recommendations for further improvements.

Government's analysis and discussion of its financial results and condition continues to improve, but more disclosure of risks, uncertainties and long-term trends is needed

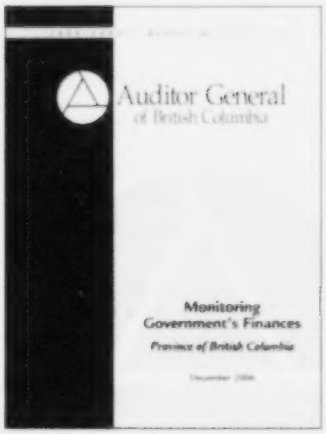
As already noted, the Public Accounts is the key financial report that Canadian governments use to report on their financial results, position and condition. The Public Accounts must include not only audited summary level or consolidated financial statements, but also a full explanation of the state of their finances and describe financial performance for a general audience. However, because the Summary Financial Statements cannot meet the needs of all intended readers and users, governments must provide additional information to better explain their financial accountability and performance.



The Public Accounts is the primary financial report that Canadian governments use to report on their finances.

For the past six years we have published a report titled *Monitoring Government's Finances* (www.bcauditor.com/) to provide legislators and the public with a clearer analysis and discussion of government's finances and financial performance. We published our first one in February 2002 (commenting on the 2000/01 fiscal year). At that time, there was little guidance on the form and content of this type of public sector reporting.

Improved Presentation and Other Accounting Changes



We have published an annual report on government's finances, partly to fill a need we saw for clearer discussion and analysis.

The *Monitoring Government's Finances* report made note of important trends and events that helped explain government's finances and answered the simple question, "How are we doing?"

Since our first report in 2002, we have seen steady improvement in government's reporting on its financial performance outside of the Summary Financial Statements. In the financial statement discussion and analysis (FSD&A) section that precedes the Summary Financial Statements (see Appendix C), government has expanded the discussion of its financial performance since it started this practice in 2004. Furthermore, the *Financial and Economic Review*, an annual government report separate from but published around the time of the Public Accounts, has also made advances in its chapter on financial performance (see www.fin.gov.bc.ca/tbs/F&Ereview07.pdf).

As a result of this progress, we no longer believe that our Office needs to publish a separate report on government's finances.

Nevertheless, we do offer several recommendations that we believe would result in further improvements. These recommendations are summarized at the end of this section (Exhibit 1).

Recommended content for discussing governments' finances

In 2004, PSAB published a Statement of Recommended Practice (SORP-1). Although not part of GAAP, such statements offer guidance to encourage governments to improve their financial reporting. This statement, SORP-1, outlines the preferred FSD&A content for governments and why this information is important to compile for readers. It calls for an FSD&A that, in addition to calling for particular disclosures with a defined framework, includes:

- qualitative characteristics[2] such as understandability, relevance, reliability and comparability;
- a summary of the significant events that affect the financial statements;

[2] Readers may be interested in reviewing SORP-2 Public Performance Reporting issued by PSAB in September 2006. It offers guidance for preparing performance information for government annual reports. It complements the guidance on qualitative characteristics embodied in SORP-1. There is also considerable similarity between the principles in SORP-2 and the BC Reporting Principles endorsed in November 2003 by government, the Select Standing Committee on Public Accounts, and the Auditor General.

- an analysis of risks and a discussion of the strategies, policies and techniques adopted to manage them;
- a description of the variances to the Budget and to the prior year; and
- a trend analysis of the major financial statement components.

This type of discussion and analysis has been provided by public companies to stakeholders for many years, and the FSD&A guidance offered by PSAB is crafted on the notion that providing such an analysis helps readers better understand the matters that affect the financial results, position and condition of government.

Although the British Columbia government meets a number of the recommended practices for financial reporting in its FSD&A, we found there are still reporting gaps, although some of these are met in government's *Financial and Economic Review*.

Indicators of financial condition

In 1997, the CICA published a research report titled *Indicators of Government Financial Condition*. The indicators describe key relationships, ratios and trends intended to assist legislators, decision-makers and the public in evaluating the financial trade-offs related to policy decisions, and in better understanding the overall financial condition of government.

As well, the indicators help financial statement users monitor the financial condition of the federal and provincial governments in terms of three main concepts:

Sustainability — the ability of a government to maintain existing programs and meet existing creditor requirements without increasing the debt burden on the economy. In other words: Can government continue to raise revenue in order to spend the way it does now?

Flexibility — the degree to which a government can increase financial resources to respond to rising commitments by either expanding its revenues or by increasing its debt burden. In other words: If government were to increase its spending, how much room is there in the provincial economy for it to pay for the spending by increasing either taxes or debt?

CICA Key Indicators of Government Financial Condition

Sustainability indicators:

1. Net liabilities to gross domestic product
2. Change in net liabilities to gross domestic product

Flexibility indicators:

3. Public debt charges to revenue
4. Changes in physical capital stock
5. Own-source revenue to GDP

Vulnerability indicators:

6. Government-to-government transfers to own-source revenue
7. Foreign currency debt to total government debt

Vulnerability — the degree to which a government becomes dependent on, and therefore vulnerable to, sources of funding outside its control or influence. In other words: Does government rely too much on revenue from the federal government — revenue that it is unable to control from year to year? Generally, a province can control its taxation policies, but it cannot directly control the annual transfer of funds from the federal government.

In past *Monitoring Government's Finances* reports, we have reported on seven key indicators of financial condition (see sidebar), showing trends going back to 1997. Although it encourages us to see that government is now using most of these indicators of financial condition in the FSD&A of the Public Accounts, most of the long-term trends are still reported in its *Financial and Economic Review*.

Financial condition indicators are under review

In September 2006, PSAB initiated a project to update and build on the work done in the 1997 CICA research study. There were several reasons for doing this — most notable, the need to stay current with accrual accounting adopted over the previous decade across the country and the need to bring in guidance for local governments.

The objective of the project is to issue a new Statement of Recommended Practice with recommended guidance, for each level of government, on the reporting of indicators of financial condition. Government officials from all levels, various stakeholder groups and legislative auditors will have an opportunity to comment on and provide input to the new guidance, which is scheduled to be in place in late 2008. One area of guidance will pertain to comparability of indicators between jurisdictions, which the British Columbia government has commented on in several of its responses to our *Monitoring Government's Finances* reports.

Government's latest FSD&A

Government's FSD&A in the 2006/07 Public Accounts is an improvement over that in last year's, but it does not yet incorporate all the recommendations of our past *Monitoring Government's Finances* reports. However, government has committed to either adopting our outstanding recommendations or reviewing them in the future.

With respect to those recommendations:

- Although the FSD&A in the Public Accounts now contains four years of trend information, the financial review section in the *Financial and Economic Review* contains financial information for the past nine years (and longer in some cases). We have been recommending that some of this information would be better placed in the FSD&A because readers need this context and are not likely to look further for it in another publication.

  Government's response has been that it does not wish to publish financial trends in the FSD&A from before 2004/05 (when the Summary Financial Statements were first published under legislated GAAP). Nevertheless, we continue to believe that our recommendation for longer-term trend information in the FSD&A is valid.

- Neither the FSD&A nor the *Financial and Economic Review* refers to the other. We recommended that if government does not yet wish to publish long-term trends in its FSD&A, it at least ensure the two documents reference each other and include location information.

- In *Monitoring Government's Finances* last year, we recommended that government include more risk analysis and discussion in its FSD&A. Although we found that risks are discussed in several of the 2006/07 FSD&A sections and summarized in a small back section called "Risks and Uncertainties," we did not find sufficient discussion of government's plans and strategies for managing uncertainty. We believe that a full discussion of how well key risks were managed is essential to enable readers to assess and understand government's current and future financial vulnerabilities.

- Disclosure needs to be further expanded to discuss in more detail the relationship between the budgeting and reporting processes and how government is managing its key financial risks and uncertainties. For example, in its quarterly financial reports, government provides considerable analysis and discussion of financial performance relative to the budget, as well as of inherent risks and uncertainties. There is no equivalent discussion in the FSD&A—although, as noted above, the *Financial and Economic Review* covers some of this.

Exhibit 1 shows the status of the recommendations from our last *Monitoring Government's Finances* report, as well a new one.

Exhibit 1

Status of recommendations related to government's financial statement discussion and analysis

Prior Year Recommendations	Government's Response and Status Update	Recommendation Status or New Recommendation
1. *We recommend that government present a long-term trend analysis in the financial statement discussion and analysis (FSD&A) so that it can provide more context for discussing government's financial performance.*	*"Additional years of trend analysis will be added as information becomes available and is audited by the Auditor General."* ***Update:*** *Government included a fourth year of trend information in the 2006/07 Public Accounts.*	***Not met.** We continue to recommend long-term trend analysis in government's FSD&A.* ***New recommendation:*** *Government should cross- reference between the FSD&A and its Financial and Economic Review.*
2. *We recommend that government expand its FSD&A to better cover material financial risks and uncertainties and the challenges involved in their ongoing management.*	*"We agree that disclosure of risks and uncertainties is important to the users of financial statements and are once again committed to leading senior governments in Canada by developing relevant disclosure to help the users of our financial statements understand the context of the province's financial plans and results."* ***Update:*** *Some additional information was provided in the 2006/07 FSD&A.*	***Partially met.** Although progress was made, we continue to encourage government to expand its disclosure in this area.*

Prior Year Recommendations	Government's Response and Status Update	Recommendation Status or New Recommendation
3. *We recommend that government include all relevant indicators of financial condition in its FSD&A, shown over an extended period to supplement the existing discussion and analysis.*	*"Currently the government provides this information in other documents such as the Financial and Economic Review. As our financial reporting in the Public Accounts continues to evolve in step with emerging best practices in Canada, we will continue to evaluate all relevant information, including indicators of financial condition in the FSD&A in a way that provides a comprehensive and accessible picture to the users of our financial statements."* ***Update:*** *New indicators were added to the 2006/07 FSD&A.*	***Fully met.*** *All key indicators are now included in government's FSD&A.*
4. *We recommend that government adopt the use of the CICA-recommended measure of "government-to-government transfers to own-source revenue" for use in the FSD&A.*	*"The government used a very similar measure called government-to- government transfers to total revenue; while the calculation of the ratio differs slightly (from the CICA recommendation) the result remains the same.* *Deciding to change the way this indicator is calculated requires weighing the benefit of continuing to report on a basis consistent with prior years, against the benefit of reporting on a basis that will be consistent with other jurisdictions when they adopt the same recommendations in their financial statements. We will monitor the reporting of other jurisdictions as well as review any new guidance to determine which of these indicators would be appropriate for the next Public Accounts."* ***Update:*** *Government continued using total revenue in the ratio in its 2006/07 FSD&A.*	***Not met.*** *Using total revenue includes government transfers, which understates the degree of vulnerability.* *We continue to recommend own-source revenue, as it shows a more concise picture of vulnerability to revenue sources beyond government's control.*

Government should disclose more details of its contractual obligations

Beginning with the 2005/06 Summary Financial Statements, government has been increasing the disclosure of its contractual obligations. A contractual obligation is a legally binding commitment government enters into, requiring it to make payments in future years. Examples are leases of buildings and equipment, contracts for services such as payroll, and various P3 (public-private partnership) agreements government has entered into. Under GAAP, disclosure must now be made of contractual obligations that are significant in relation to government's current financial position or future operations.

The provincial government determined that obligations over $50 million would be deemed significant. We accepted this, although we are concerned that a sizeable amount could go unreported if a large number of entities had obligations close to, but less than, the $50 million threshold.

In a note to the financial statements, government now discloses its total obligations for each of the next five years, an amount for periods beyond that, and the grand total.[3] It also improved and expanded its 2006/07 disclosure by showing the contractual obligations of government business enterprises separately.

We believe this disclosure could be improved further by segregating the obligations related to capital expenditures from those for operating expenditures and adding descriptions of their nature. This would help readers understand the types of obligations that government is committed to. As well, separating capital from operating commitments makes it easier to assess their respective impacts in future years. Approximately $3 billion of the $55 billion disclosed as at March 31, 2007, relates to capital expenditures.

Exhibit 2 is an example of the type of disclosure we feel would be more useful than what is currently shown in the Summary Financial Statements.

Recommendation 4

We recommend that government disclose contractual obligations for operating expenditures and capital expenditures separately on a comparative basis, and include a summary description of the nature of the expenditures.

[3] Note 25(d) on page 64 of the Public Accounts.

Exhibit 2

Sample pro forma contractual obligations note, segregating capital and operating amounts, and including a column showing prior year totals.

In $ Millions

	2008	2009	2010	2011	2012	2013 and beyond	Total as at March 31, 2007	Total as at March 31, 2006
Operating								
Taxpayer-supported Crown corporations and agencies								
Health	983	615	572	553	560	2,197	5,480	1,218
Social services	272	17	5	1	–	–	295	295
Other	87	97	87	70	53	247	641	558
Natural resources and economic development	19	22	73	11	11	196	332	311
Protection of persons and property	272	265	265	264	264	–	1,330	1,544
Transportation	504	509	571	586	594	10,619	13,382	11,711
General government	396	380	221	199	176	337	1,708	646
	2,532	1,904	1,793	1,684	1,659	13,596	23,169	16,344
Self-supported Crown corporations and agencies								
Natural resources and economic development	1,852	1,136	1,132	1,304	1,403	22,268	29,095	14,587
General government	53	41	30	19	8	28	179	
	1,905	1,177	1,162	1,323	1,411	22,296	29,274	14,587
Total Operating	4,437	3,081	2,955	3,007	3,070	35,892	52,443	30,931
Capital								
Taxpayer-supported Crown corporations and agencies								
Education	200	86	26	11	2	6	331	502
Natural resources and economic development	209	39	28	28	28	688	1,018	1,305
Transportation	379	85	29	20	20	547	1,079	1,275
	787	210	82	59	50	1,240	2,427	3,082
Self-supported Crown corporations and agencies								
Natural resources and economic development	175	76	111	–	–	–	362	
Total Capital	962	286	193	59	50	1,240	2,792	3,082
Total Operating and Capital	5,400	3,367	3,148	3,066	3,119	37,132	55,233	34,012

Source: Prepared by the Office of the Auditor General from government prepared working papers.

Sample summary description for operating contractual obligations related to transportation:

Transportation includes significant operating contractual obligations for payments to BC Ferries and payments for road maintenance and the operating portion of P3 agreements for the Sea-to-Sky Highway, the W.R. Bennett Bridge, and the Kicking Horse Canyon Highway Improvement Project.

Improved Presentation and Other Accounting Changes

The disclosure of contingent liabilities has been improved

A contingent liability exists when some event has happened, but government will not know until other events occur in the future whether or not it has a liability.

The most common contingent liabilities are lawsuits claiming damages from the government, wherein the plaintiffs are alleging to have suffered losses for which government should pay damages. Since these matters are in dispute, the possible government liability cannot be determined until the point in the future when the lawsuit is settled.

Government classifies lawsuits for financial reporting into two categories: those that are "likely," meaning that government's legal counsel believes there is a high probability of having to pay some damages; and those that are "unlikely or not determinable." For those deemed likely, government determines if it can estimate how much it may have to pay, which could be less than the full amount claimed, even if the plaintiff wins the case.

If government can make reasonable case-by-case estimates of the amounts it is likely to pay, it accrues these amounts as liabilities in its financial statements. It also discloses the amounts claimed in excess of the liability it has accrued, if that is the situation. For those cases where it cannot make reasonable estimates and so does not accrue any liability, it discloses in the financial statements the total amounts claimed.

An overriding principle government follows is that it will not disclose any information that could have an adverse effect on the outcome of a lawsuit.

Historically, the amount claimed has exceeded the amount paid out by quite a wide margin. As a result, we believe that disclosing the full amount claimed has tended to overstate the potential liability.

This year, to make the disclosure more useful, where government could, it disclosed its best estimate of the liability, rather than the amount claimed. The amount disclosed is thus a better indicator of the potential maximum liability than was the case in the past.[1]

[1] Note 25(b) on page 61 of the Public Accounts.

Improved Presentation and Other Accounting Changes

Disclosure around the use of estimates has expanded, but government should show more about which financial statement items are affected, and the impact of changes made to prior year estimates

The preparation of most financial statements necessarily involves the use of estimates, and two types of disclosure are recommended—information about the "measurement uncertainty," a phrase used in the accounting profession to describe the inherent imprecision in any estimating process, and information about the impact on the current period of changes in prior year estimates.

Measurement Uncertainty

Starting in fiscal 2005/06, government was required to disclose all significant areas where measurement uncertainty exists and the extent of the uncertainty. Government has defined "significant" to mean where estimated amounts could vary by more than $10 million, and it has disclosed amounts where this is so.[5] For example, because estimates are used to determine revenues from personal income taxes, government disclosed in the 2006/07 Summary Financial Statements that actual revenue could be up to $200 million lower or up to $300 million higher than the amount recorded.

Government has been gathering information from ministries and the organizations that make up the government reporting entity in order to comply with the disclosure requirements. This has put additional demands on both central government and its organizations, as government now discloses more information in its Summary Financial Statements about measurement uncertainty than the organizations do in their own financial statements. Government is still developing the best way to gather the information. Currently, government only requires ministries and organizations to report measurement uncertainty that exceeds $10 million. This means that smaller amounts are unreported, even though the total for a particular item in the financial statements, if all the smaller amounts were added together, could well exceed the $10 million threshold. Government is looking at ways it can identify whether the total of unreported uncertainties is significant.

[5] Note 2 on page 42 of the Public Accounts.

We found that although the nature of the items where measurement uncertainty exists is well described in the Summary Financial Statements, it is often unclear where the items are recorded, which reduces the usefulness of the information to readers. For example, a reader unfamiliar with government finances probably would not realize that the measurement uncertainty item described as "softwood lumber payments" is a transaction included in the revenue line "natural resources."

Recommendation 5

We recommend that government disclose the financial statement lines where the items subject to measurement uncertainty are recorded.

Impact of changes made in prior period estimates

The PSAB handbook says that when change occurs in an estimate made in the previous year, disclosure of the nature and effect on the current period may be desirable if the change is rare or unusual. We believe that government should, as a best practice, disclose such changes.

For example, estimates of economic factors are used to calculate the revenue from personal income taxes (as disclosed in Note 2 on page 42 of the Public Accounts). The effect of updating government's estimates made in prior years, using more current information, resulted in an additional $452 million of revenue in 2007. This is useful information that should be disclosed.

Recommendation 6

We recommend that government disclose details of significant changes in prior year accounting estimates.

Comprehensive income is newly included in the statement of operations but not in the annual surplus (deficit) — a change readers may find hard to understand

"Financial Instruments" is a new CICA accounting standard that government business-type organizations and government business enterprises are adopting. It results in a new line item in their financial statements called "other comprehensive income" (OCI)[6].

Government business enterprises (such as BC Hydro and ICBC) and government business partnerships are organizations that carry on a business and are self-supporting. Government "business-type" organizations are taxpayer-supported organizations that carry on a business but do not support themselves from their earnings. Both may include OCI in their financial statements as they are required under GAAP to report on the same basis as the private sector.

OCI is reported on the income statement as a separate item after net income — it is not part of net income. PSAB has determined that governments that consolidate entities which show OCI on their income statement should not report this item as part of their surplus (deficit) for the year on their statement of operations (their equivalent of the "income statement"). Rather, they should do so in the statement that reconciles the change in accumulated surplus or deficit, and in the statement of changes in net debt.

As a result of this PSAB standard, if any government organization is reporting OCI on its statements of operations, then adjustments will have to be made so that this item is not carried through to the Summary Financial Statements and reported as part of the surplus (deficit) for the year. These adjustments will be like the usual ones made during the consolidation process to ensure that the results of all included organizations are prepared using the same accounting policies as government.

[6] "Other comprehensive income" consists of the change in market value of financial assets available for sale (to be distinguished from financial assets held for trading or held to maturity), and changes in the fair values of effective cash flow hedging instruments, and gains and losses arising from the translation of the financial statements of a self-sustaining foreign operation.

Government business enterprises are an exception to this process. They are consolidated using the modified equity method (their net earnings are reported as income of the government, instead of all their revenues, expenses, assets and liabilities being consolidated). Normally, there is no adjustment for different accounting policies that government business enterprises might follow. In this case, however, PSAB specifically requires adjustments to be made for any government business enterprises that have reported OCI.

The financial instruments standard is not mandatory until fiscal 2007/08. However, one government business enterprise, the Insurance Corporation of British Columbia (ICBC), adopted the change in its first quarter results for the period January 1 to March 31, 2007 which are included in the consolidation of the 2006/07 Summary Financial Statements. The effects of OCI reported in ICBC's financial statements is appropriately shown as an adjustment through the accumulated surplus, reconciled on the bottom of the Statement of Operations in the Summary Financial Statements.[7] For 2008/09, more adjustments will be required, as other government business enterprises start reporting under this new standard.

Because accounting for several business-type university- controlled organizations changed, government needs to provide additional disclosure in the financial statements

Universities in British Columbia follow not-for-profit accounting standards, which vary in some instances from the PSAB standards that government follows. Significant differences in such accounting policies are adjusted to comply with PSAB standards when entities are consolidated on a line-by-line basis in government Summary Financial Statements.[8]

During fiscal 2006/07, universities changed their accounting policy for consolidating the results of some of their controlled entities. To do so, they first had to assess whether the change would result in a more appropriate presentation of events or transactions in their financial statements, as required by the CICA. They concluded it would, taking the position that, because the

[7] See page 34 of the 2006/07 Public Accounts.

[8] See Glossary in Appendix A for an explanation of line-by-line consolidation.

A government business enterprise is an organization that:

- is a separate legal entity with the power to contract in its own name and to sue and be sued;
- has the financial and operational authority to carry on a business;
- sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity; and
- can, in the normal course of operations, cover its expenses from those sales.

activities of these entities are not considered core to their mandate, the equity method is more representative of both the relationship and business purpose of these organizations.

In previous years, these controlled entities were line-by-line consolidated by universities. Under the new accounting policy, universities now consolidate them using the equity method.[9] Either method is acceptable under not-for-profit accounting standards, but under PSAB standards, an entity must be line-by-line consolidated unless it meets the definition of a government business enterprise (see sidebar).

If an entity meets the definition of a government business enterprise, it is consolidated on a modified equity basis in government's Summary Financial Statements. (For details of entities consolidated on a modified equity basis, see pages 82 and 83 of the Public Accounts.) PSAB standards on consolidation require government to ensure that accounting policies of governmental units conform to those of government. For this reason, the universities' change in policy required government to assess whether the controlled organizations accounted for by the universities on an equity basis met the definition of a government business enterprise and therefore warranted being accounted for on a modified equity basis in government's financial statements.

Government's review determined that some controlled organizations did not in fact meet the definition because they did not sell goods and services to individuals and organizations outside the government business enterprise as its main activity. To ensure that its financial statements continued to comply with PSAB standards, government thus changed the universities accounting treatment for significant entities of such organizations, to a line-by-line consolidation in the government financial statements.

The universities' change in policy for accounting for their controlled organizations that met the definition of a GBE affected the Summary Financial Statements by decreasing assets by $165 million (2006: $83 million decrease), decreasing liabilities by $165 million (2006: $83 million decrease), decreasing revenue by $14 million (2006: $16 million decrease), and decreasing expense by $14 million (2006: $16 million decrease).

[9] See Glossary in Appendix A for an explanation of the modified equity method of consolidation.

The entities responsible for these effects met the definition of a government business enterprise, but they were not noted in the detailed disclosure on pages 82 and 83 of the Public Accounts as required by PSAB standards.

We also point out that the CICA has recently released the draft of a new standard for changing the accounting followed by not-for-profit organizations (proposed to come into effect on or after January 1, 2009). This new standard would remove the current option of accounting for controlled entities by either the equity method or consolidated on a line-by-line basis, requiring instead that all controlled entities be line-by-line consolidated. If this proposed standard comes into effect, the controlled entities that were changed to equity accounting this past year will have to be changed back again to be line-by-line consolidated for the fiscal year ending March 31, 2010 at the latest.

Recommendation 7

We recommend that, as required by PSAB standards, the university-controlled organizations (and any other organizations) that meet the definition of a government business enterprise and are accounted for on the modified equity basis be disclosed in the government's financial statements—in the Statement of Financial Position for Self-supported Crown Corporations and Agencies and the Summary of Results of Operations and Statement of Equity for Self-supported Crown Corporations and Agencies.

In addition to the recommendations above that we made concerning government's changes in last year's Public Accounts report, we offer several new recommendations for further improvements.

Additional capital lease information is needed

Financial reporting standards, including PSAB's, require leased capital property to be accounted for as tangible capital assets and liabilities. Such accounting ensures that government is accountable for all tangible capital assets available for its use. It also ensures that all types of government's long-term financing arrangements of its capital assets are reported in the financial statements. For the year ending March 31, 2007, government incorporated information on leased capital assets by way of inserting a footnote on the tangible capital assets schedule.[10]

The footnote describes assets held on capital leases by asset type, disclosing the historical cost, accumulated amortization and net book value on a comparative basis. This information is required disclosure according to PSAB, but we found it difficult to read in its current presentation. In our view, it would be more useful to readers to disclose this information by way of a separate table, similar to one on tangible capital assets that this footnote relates to.

Recommendation 8

We recommend that government create a table for tangible capital assets under lease similar to the table presentation used for the current statement of tangible capital assets.

PSAB standards also require disclosure of the liabilities related to leased tangible capital assets. These should be shown separately from other liabilities, and should disclose information on interest rates, expiry dates and significant conditions of lease agreements such as future contractual obligations, purchase options, terms of renewal and contingencies, and circumstances that require or result in government's continuing involvement in the contractual arrangement. Government is not currently disclosing this information.

[10] On page 84 of the Public Accounts.

Recommendation 9

We recommend that capital lease related liabilities be disclosed separately to meet PSAB standards on leased tangible capital assets.

Regular assessment of long-term liabilities and better disclosure about the nature and effect of material errors is needed, such as the Vancouver Island Natural Gas Pipeline Agreement accrual

Terasen Gas (Vancouver Island) Inc. and the Province are signatories to the Vancouver Island Natural Gas Pipeline Agreement in 1995. The agreement was part of a financial restructuring of the natural gas transmission and distribution companies on Vancouver Island. Included in the agreement is a payment made to Terasen by the Province that is tied to the royalties British Columbia collects on natural gas production. In 1995, the Province recorded a $75 million liability related to this, calculated based on the estimated gas prices at that time. Each year this liability has been drawn down by the original estimated payments (set volumes × estimated price). However, actual payments by the Province have been based on the volumes set in the agreement and the current calendar gas price.

During fiscal 2000/01, when natural gas prices started to rapidly climb, the liability was reassessed. However, no adjustment was made, because it was unknown whether the price increase would be temporary or permanent over the term of the agreement. Government had planned to reassess the liability within the following two years, but did not.

Had the liability been reassessed in fiscal 2002/03 as planned, an adjustment would have been recorded to increase the pipeline agreement liability recorded in government's financial statements. Not doing so resulted in a material financial statement error of understated liabilities.

Current gas prices continue to be much higher than originally forecasted in the agreement. Therefore, the original liability has not represented the true cost to the Province since fiscal 2000/01. For fiscal 2006/07, government retroactively corrected this error in accordance with PSAB guidance. The liability was increased by $168 million, for an ending liability balance as at March 31, 2007, of $180 million.

Although the error was correctly accounted for in 2006/07 but not earlier, we believe that government did not adequately disclose it in the Summary Financial Statements. When there is a correction in the current period of an error in prior period financial statements, PSAB requires:

- a description of the error;
- a description of the effect of the error correction on the financial statements of the current and prior periods; and
- disclosure of the fact that the financial statements of prior periods that are presented have been restated.

We found such disclosure in government's financial statements for 2006/07[11] to be deficient, showing only an adjustment to the opening accumulated deficit for 2005/06 and to the opening deficit for 2006/07. The note does not describe the error, but rather only what it relates to. As well, the fact that the financial statements of the prior period have been restated is not shown. Standard practice is to put "as restated" over the top of the prior period columns on the face of the financial statements to highlight this fact.

Recommendation 10

We recommend that government regularly assess long-term liabilities to ensure they are a true and fair reflection based on the most recent information available.

Recommendation 11

We recommend that when government corrects material errors in its financial statements, it also provide a description of the error and the effect of the correction, and that it head the prior period columns on the face of the financial statements "as restated."

[11] Note 24 on page 60 of the Public Accounts.

Public-private partnership arrangements continue to dominate government capital procurement, and accounting for them remains complex

The Gordon and Leslie Diamond Health Care Centre is an example of a government capital project carried out under a P3 procurement and financing model.
Source: PSPBC website

In the past few years, the provincial government has used a public-private partnership (P3) procurement and financing model as its preferred method for large public sector capital projects. According to Partnerships BC (the Crown corporation set up to develop P3s), about a dozen of these projects are either operational or under construction in the province, and another four are in the procurement process.

Government has also recently implemented a new policy where the P3 model will be the "base case" for all provincially funded capital projects over $20 million. This policy applies to any ministry, Crown agency and other agency within the government reporting entity. It also applies to local government projects where the Province is contributing more than $20 million to the capital cost.

Given the Province's expanded policy with respect to P3 arrangements, we think it is important for government to continually assess its accounting framework to ensure it meets current accounting standards and reflects the economic substance of these transactions.

Over the past year, government has continued to assess how facilities constructed under P3 arrangement should be appropriately valued in its financial statements—both the assets created and liabilities assumed. Recently the Province developed a framework for making these assessments. We reviewed it and believe it will provide a reasonable foundation by which to value P3-constructed assets going forward.

Accounting for resource roads continues to be reviewed

British Columbia has thousands of kilometres of resource roads used for a variety of economic and recreational purposes.

Resource roads are currently defined by government to include forest roads, mining and mineral claim access roads and petroleum development roads.

Photo courtesy of Ministry of Transportation

In our report last year on government's financial statements, we recommended that government review its policy on accounting for resource roads to see whether some roads should be capitalized. During fiscal 2006/07, government began to review the issue.

It has begun its review in the Ministry of Forests, starting by defining the population of resource roads. Four main categories have been identified: non-industrial, industrial, permit and non-status (see following page). Exhibit 3 shows the estimated total length of these roads by category.

Exhibit 3

Estimated total length of major forest roads in British Columbia, by category

Non-industrial		Industrial	Permit	Non-status
Community	1,170	Licensees 24,000	155,000	170,000 – 200,000
General	6,400	BC Timber Sales 19,000		
Recreational	2,800			

Note: Estimated kilometres as at September 2007. The categories and the respective kilometres are not fixed, as the classification use of the roads may change. For example, roads previously designated as non-industrial general use can change to industrial use, community, recreational or residential access, and roads previously designated as industrial use can become community, recreational or residential access. This can result in significant fluctuations each year. In 2006, for example, there were 3,100 km of recreational roads and in 2007 there were 2,800 km.

Source: Ministry of Forests

Photo courtesy of Ministry of Transportation

Forest Road Types

Non-industrial – Roads where there is no primary industrial user to delegate maintenance responsibility to, so the Province is responsible for maintenance. These include roads providing community,[12] residential and recreational access. These are similar to highways, except for the road quality. The scope of recreational access use has yet to be defined, but is similar to the land improvement asset class for provincial parks.

Industrial – Roads constructed by the Province where the maintenance responsibility is delegated to a road use permit holder (i.e., a licensee).

Permit – Roads that are constructed, maintained and deactivated by the forest industry under road permits.

Non-status – Roads that are not in active use and not managed by the ministry or any other agency, and for which no one is identified as having the responsibility to maintain or deactivate these roads.

Given the range of types of resource roads, each category must be evaluated separately to determine whether it meets the definition of a tangible capital asset. During fiscal 2006/07, government assessed that community access roads did meet the definition under current policy for road capitalization. They were recorded in government's financial statements, which increased tangible capital assets by $50 million (2006: $50 million) and accumulated amortization by $29 million (2006: $28 million).

We had hoped government would have made more progress in its evaluation of resource roads last fiscal year, but we will continue to work with the Office of the Comptroller General and several ministries on this issue. While research started this year in the Ministry of Forests, it will also need to be completed for the Ministry of Energy Mines and Petroleum Resources to complete an assessment of capitalization for resource roads in its portfolio.

Recommendation 12

We recommend that government complete its assessment of accounting for resource roads in fiscal 2007/08 and record the applicable roads as tangible capital assets in the Summary Financial Statements.

CICA standards also require accounting for the decommissioning of assets—or "asset retirement obligations." In conjunction with recording resource roads as tangible capital assets, government must also consider whether a liability for decommissioning roads must also be recorded, where a reasonable estimate of the fair value of the obligation and the future settlement date of the retirement of the road asset can be determined.

Recommendation 13

We recommend that government assess where asset retirement obligations should be recorded for applicable resource roads and recognize those obligations in their financial statements.

[12] A community is defined as a populated First Nations reserve, or a populated centre that has a Canada Post office or a school or that is served by school buses provided by the school district.

Employee pension plans disclosure improved

Given the significance of retirement benefit plans on government's finances, it is important for financial statement users to have full disclosure in order to assess the impact these pension plans have on the results of operations and financial position of government.

For the fiscal year ended March 31, 2007, government reorganized the financial statement note[13] that discloses information on employee pension plans, which we believe makes it easier for readers to follow. As well, the note now includes additional information on important plan assumptions, including expected long-term inflation rates, dates of audited financial statements and preliminary overall fund rates of return; and it further meets PSAB requirements by disclosing the Province's contributions to the plans for the current year.

Although improvements have been made, the note to the employee pension plans still does not contain the minimum information that the PSAB standard requires. For example, it does not disclose the current period benefit cost (i.e., the pension expense) or the amount of contributions by employees during the year for any of the plans.

Also, while the note contains a reference to a website where more information can be found on the joint trustee plans, government financial statements should be complete in themselves, and providing references to other financial statements and reports is not a substitute for disclosure in the financial statements. We therefore believe that by providing such a reference (i.e., to the website), government is not fulfilling the required disclosure standard of including this information in its financial statements.

Recommendation 14

We recommend that government fully implement the remaining PSAB standards on retirement benefits to meet the minimum required disclosure.

[13] Note 16 on pages 50-52 of the Public Accounts.

Updates on Issues from the Prior Year

Post-employment benefits disclosure expanded

For the fiscal year ended March 31, 2007, the Province expanded its note disclosure of post-employment benefits[14] by providing in a table a breakdown of the amounts by category describing the nature of the benefits.

The requirement for post-employment benefits disclosure is similar to the requirement for pension plan disclosure, although it varies depending on the nature of the benefit. PSAB also requires disclosure of the information about key assumptions, a reconciliation of assets and accrued benefit obligations from the beginning of the fiscal year to the end of it, and the cost of the current period benefit. Government is currently not providing this key information in its note for post-employment benefits.

Recommendation 15

We recommend that government fully implement the PSAB standard on post-employment benefits to meet the minimum required disclosure.

Disclosure of interest expense has improved, but should also be shown in a single place

Before fiscal 2006/07, part of the cost of government's borrowing was disclosed on its statement of operations as interest expense. The rest was combined with health, education and transportation costs.

We were pleased to see that, starting in fiscal 2006/07, government now discloses interest as a single item on the statement of operations.[15]

However, we also found that interest paid on capital leases is being grouped with "other" expenses, so once again all of the interest is not shown on the same line in the financial statements. Interest expense is a significant part of government's total expenses, and so we believe that showing interest on one line helps readers understand the full extent of the government's interest expense.

[14] Note 12 on page 49 of the Public Accounts.

[15] Page 34 of the Public Accounts.

Recommendation 16

We recommend that government include all interest in a single line item on the financial statements.

Disclosure of the 2010 Olympics Games commitment in the government financial statement should be expanded

For several years, we have reported that government has only disclosed a commitment of $600 million for the 2010 Olympic and Paralympic Winter Games in its Summary Financial Statements. In the notes to the 2006/07 Summary Financial Statements,[16] a commitment and the amount spent against it to date—$272 million—is shown.

We believe, for several reasons, that this commitment is understated, an opinion we explain in detail in our September 2006 report *The 2010 Olympic and Paralympic Winter Games: Review of Estimates Related to the Province's Commitments* (available at www.bcauditor.com; an update report will be published in early 2008).

In particular, it does not include government's promise to the International Olympic Committee (IOC) to upgrade the Sea-to-Sky Highway. Although the amount spent to March 31, 2007 —$357 million—is disclosed later on in the text of the note, the remaining commitment amount is not mentioned there. The remaining estimated total commitment assuming 2% inflation and maximum performance payments, $1,626 million (which includes payments for maintenance after 2012), is included as part of the total government contractual obligations in the transportation sector.[17] The remaining capital portion of the Sea-to-Sky Highway, which we believe constitutes part of the commitment to the Olympics, has not been disclosed separately.

As well, the note does not disclose separately the other Games-related commitments that government has made, such as funding for the British Columbia 2010 Olympic and Paralympic Winter Games Secretariat and construction of the Callaghan Valley roads. Although this is not specifically required under PSAB

[16] Note 25(c) on pages 63 and 64 of the Public Accounts.

[17] Included in the total of note 25(d) on page 64 of the Public Accounts.

standards for disclosure of contractual obligations, we believe that, given the significance of this undertaking and for transparent public reporting, government should include all Games-related commitments in one place: its Olympics commitment note.

Recommendation 17

We recommend that government disclose its complete Games-related commitments in its Olympics commitment note.

Government's policy on capitalized interest during construction should be consistently applied

When an organization constructs a building or large capital asset, a generally accepted accounting practice is to include interest paid on money borrowed to finance construction as part of the cost of the asset. Capitalizing this interest ceases when construction is complete and the asset is put into use. From then on, any financing costs are expensed.

The Province's accounting policy is to capitalize interest charges on money borrowed to finance construction until the project is 97% complete. For highway construction and rehabilitation projects, interest during construction may be capitalized if the project is over $100,000. On capital projects over $5 million, interest during construction may be capitalized if it exceeds $250,000.

For the last three years, however, interest was capitalized on one construction project despite the fact that there was no specific borrowing for that project.

Since 2004/05, the Province has capitalized interest costs of almost $4 million as part of the cost of constructing the Vancouver Convention Centre Expansion. Although the Province is funding the construction (with the participation of the federal government and Tourism Vancouver), it has not specifically borrowed for the project. The interest it has capitalized is calculated as the Province's share of the amount spent on construction, times the average interest rate for the year on the total borrowing of the Province.

Although we support the practice of capitalizing interest during construction, doing so on this particular project makes us wonder about the lack of consistency in how the policy is applied across government and how the calculation is made. We note, for instance, the following:

- Interest has been attributed to the funding provided for the Vancouver Convention Centre Expansion, assuming that the funding came from general borrowing, but it has not been attributed to the substantial funding that was given for construction projects in the education and health sectors, which also came from general borrowing.
- The rationale for calculating interest is that general borrowing was needed to provide the funding for the expansion. However, in each of the three years in which interest has been capitalized on the convention centre expansion so far, the Province had a surplus of revenues over expenditures that it used to reduce its total debt. (The Province's share of the total construction to date, on which the interest is calculated, is $46 million. The net debt repayments over the last three years total just under $5 billion.)

We believe that rather than assigning interest during construction in an ad hoc way, government should review its accounting policy on capitalization of interest to address these issues.

Recommendation 18

We recommend that government revise its policy on capitalization of interest during construction so that the policy is applied more logically (in terms of calculating the amount).

Recommendation 19

We also recommend that government apply its policy on capitalization of interest during construction consistently across the government reporting entity.

Accounting standards continue to evolve, especially as many national standard-setting bodies across the globe attempt to bring their standards into harmony with each other. Canada is no exception, and there are a number of new standards in the making.

Early adoption of new standards is often encouraged by PSAB, and we have recommended previously that, to the extent practical, British Columbia adopt new standards before their formal effective date. The provincial government is required by legislation to follow GAAP and adopt new recommendations. However, it has also stated that early implementation of new recommendations is not always practical or, in its view, advisable.

One proposed PSAB standard in particular, accounting for government transfers, could have a significant impact on government's financial statements.

Accounting for government transfers may change

Government transfers are funds or capital assets that are transferred from one government to another government or from a government to an individual or organization. For example, in fiscal 2006/07, the Province received $6.4 billion from the federal government and it paid $7.8 billion to local governments, organizations and individuals. PSAB is proposing a new standard for accounting for government transfers. While the proposal covers both receipts and payments of funds or capital assets, it is the accounting for the receipts from the federal government that might need to be changed.

The current standard for accounting for receipts of government transfers requires the funding to be recorded as revenue when received. Most of the transfers from the federal government are recorded that way. In 2004, however, the federal provincial Health Accord resulted in the transfer of significant funds to British Columbia for health care programs. Originally intended to be transferred over three years, the federal government instead transferred all the money during 2003/04, approximately $0.5 billion.

As well, British Columbia received further transfers during 2004/05. These totalled approximately $1.1 billion.

We advised government that we would agree with its proposal of deferring and recognizing the funds received as revenue to match the expense if it:

- deferred only those funds provided by the federal government for the specific purposes set out in the Health Accord;
- developed plans to spend those funds on the health care initiatives set out in the Health Accord;
- tracked the dollars spent; and
- developed and implemented a means to measure the effectiveness of the dollars spent that would withstand the rigour of an audit.

The alternative would have been to record the funds as revenue in the years received, something which was problematic for the government considering that some of the funding was received close to the year-end. In 2004/05, for example, $0.6 billion was received on March 30, the day before the fiscal year-end. Government could not constructively spend this money before March 31, and had it been budgeted to be spent in the following years when there was no federal revenue to offset the expense, there might have been a budget deficit. We agreed to the deferral at that time because the accounting for government transfers was still under review by PSAB, and the issue of revenue recognition and deferral was a significant factor in its deliberations.

Then, in 2005/06, we agreed to additional deferrals when amounts totalling $190 million were received for pine beetle mitigation and early learning child care programs; and again in 2006/07, when transfers totalling $31 million were received for settlement and immigration services. We supported the deferral of part of this funding as long as doing so met the same conditions noted above.

During the summer of 2007, PSAB finally released its proposed standard on accounting for government transfers. It is expected to be finalized by summer 2008, although the accounting policies will not become mandatory until the 2009/10 fiscal year. If approved in its current form, there will be significant changes in how some governments account for the transfers they make and receive.

As proposed, transfers received from the federal government will need to be recognized as revenue during the year in which the events giving rise to the transfer occur, provided that the transfer has been authorized (by the federal government) and federal eligibility criteria (if any) have been met. One eligibility criterion, for example, might be that the Province can incur expenses that comply with certain conditions and then apply to the federal government for re-imbursement (as is done, for example, with emergency program expenditures).

However, the proposed new standard will only allow deferral of revenue if there are both: *substantive performance requirements* (requirements governing how the funds are to be spent, which are specifically identifiable and can be objectively assessed for non-compliance); and *a requirement to return the funding* (or pay equivalent penalty) if those performance requirements are not met.

We note that the funding British Columbia has been deferring has performance requirements, but no return requirements. This means that the Province would not have been able to defer the transfer funding had the proposed standard been in place in 2003/04 when the first deferrals were made. This would have resulted in revenue being approximately $390 million higher in 2003/04, $770 million higher in 2004/05, $230 million less in 2005/06, and $332 million less in 2006/07.

Segmented reporting

The purpose of producing functional consolidated sector information is to provide more detail to make it easier for financial statement users to understand both the composition of the Summary Financial Statements as a whole, and the relative size and financial results of each major part. It also:

- helps users:
  - identify the resources allocated to support the major activities of government;
  - make more informed judgements about the government reporting entity and its major activities; and
  - better understand the manner in which the organizations in government are organized; and
- enhances the transparency of financial reporting.

Effective April 1, 2007, government is required to follow the new PSAB handbook standard on segmented reporting. The standard covers how to define and disclose segments in government's Summary Financial Statements.

To its credit, the Province has been disclosing some segmented information for a number of years, even though there has been no requirement to do so until this new standard was introduced. Furthermore, the Province adopted a couple of the new reporting requirements earlier than required.

For the fiscal year ending March 31, 2007, government presented its segmented reporting statements on a comparative basis, disclosing both the current and prior year comparative amounts.[18] It also disclosed the basis for identifying its segment disclosure under its significant accounting policies note.[19]

We have identified some additional changes that we believe are also necessary if government is to comply with the new standard:

- Along with disclosing the basis for identifying the segments, government will need to disclose the nature of the segments, the activities they encompass, and the method of significant allocations to segments.
- Disclosure is needed of the aggregate of the net surplus/deficit of government business enterprises and government business partnerships accounted for under the modified equity method for each segment. Any changes in segment reporting accounting policies that have a material effect on segment information must also be disclosed.
- We encourage government to produce detailed statements for each segment, and so lead by example by providing more than minimum disclosure to make financial statements more understandable to readers. The current segmented information is aggregated such that there is a breakdown by financial statement line item for sectors such as health, education, social services and so on,[20] which meets PSAB standards. However, producing supporting schedules to these sectors would make it easier for the financial statement

[18] Pages 74-81 of the Public Accounts.

[19] Note 1 (c) on page 38 of the Public Accounts.

[20] Pages 74-81 of the Public Accounts.

users to understand the finances of the separate sectors of government. For example, a schedule for the health sector would include the consolidation of the health authorities, hospital societies, related health Crown corporations and the Ministry of Health.

Recommendation 20

We recommend that, in addition to implementing the required segmented reporting standards, government continue its leading practice in this area of disclosure by producing detailed sector schedules in the Summary Financial Statements.

Government will need to review accounting for treaty accommodation and settlement costs

Treaty negotiations between the Province, Canada and First Nations have been ongoing for several years. As of March 31, 2007, British Columbia had 47 treaty tables in various stages of negotiations. Although only one treaty had been settled by then, eight agreements in principle had been signed and were pending ratification. Since then, several treaties have gone to ratification vote. For example, the Tsawwassen and Maa-nulth First Nation bands ratified their respective treaties with senior governments in July 2007.

Since treaties generally take several years to ratify, concession payments are made sometimes to First Nations prior to the full reconciliation of their interests. These concessions can take the form of interim accommodation payments where, for example, resource or other types of development activities have been proposed inside Ancestral Territories subject to final treaty negotiation. As the number of treaty negotiations increases, so does the accommodation costs.

Currently, no specific accounting guidance exists for the recognition of treaty accommodation or settlement costs. The accounting for the one treaty that has been signed was developed prior to the government financial statements being in compliance with GAAP. Given this, and with the progress in treaty negotiations, it is time to review accounting guidance to ensure a true, fair and consistent reflection of the agreements

with First Nations in the Summary Financial Statements. Government will need to assess the substance of treaty transactions to ensure all costs are appropriately and accurately recorded and disclosed in government's financial statements.

Recommendation 21

We recommend that the Province review accounting for treaty accommodation and settlement costs to ensure transactions are recorded and disclosed in a true, fair and consistent manner.

Accounting for inherited Crown land transactions is problematic

Most of the land owned by the Province was inherited through the right of the Crown. It was not purchased by the Province, and in accordance with current standards, it is also not recorded on its statement of financial position as an asset. From time to time, some of this land is sold or given away as grants.

When inherited Crown land is sold or given away as a grant, government assesses its fair value and records revenue equal to the value of the land, setting it up as an asset, and then expensing it (as a cost of sale or a grant). As a result, there is no impact on government's annual surplus or deficit unless the land is sold for cash or other consideration, in which case the sale proceeds will increase a surplus (or reduce a deficit). The amount of Crown land grants recognized in the Summary Financial Statements for 2006/07 was $31 million (2005/06: $32 million; 2004/05: $82 million, which included a $79 million grant to Parks Canada).

This accounting practice is not in accordance with PSAB's accounting guidance, which states that all items inherited by right of the Crown (such as Crown lands) should not be recognized in government financial statements, although disclosure may be appropriate. We see PSAB's current accounting treatment as problematic for several reasons:

- there is no recognition that the Crown land government is giving away has a current value associated with it;
- there is no recognition of the value of the land to future generations since it's not recognized in the Summary Financial Statements as an asset in the first place; and

- from a budget and management perspective, it may create a false belief that there is no cost associated with giving away or granting Crown land.

We believe that accounting standards for inherited Crown land is a topic that requires attention by the Canadian accounting standard setting community, especially in light of the likely convergence of Canadian to International Financial Reporting Standards, where these types of assets would be recognized in government financial statements.

The government reporting entity is not static. Each year, organizations are created by government and must be reviewed to determine whether or not they should be included in the entity. Conversely, government may wind up or extinguish some entities when they no longer serve a public purpose or as part of restructuring initiatives. Relationships between government and its organizations may also change over time, affecting the appropriate accounting treatment.

We continue monitoring the boundaries of the government reporting entity

A standard of PSAB says that an organization that is controlled by government should be included within the government reporting entity. Control is defined as the ability to influence the financial and operating policies of the organization. Government does not need to have actually influenced these policies. It just needs to have the ability to do so.

Usually, the issue of control is determined by whether or not government appoints a majority of the organization's board or other governing body—but the ability to control the organization is also an important factor.

In some cases, the legislation creating an organization provides government with clear authority to carry out its policies and programs through the organization. In other cases, the legislation establishes a governance framework that provides the organization with the authority required to determine its own strategic policies and programs independent of government. And in yet other cases, legislation creates new organizations with complex governance structures and relationships to government.

When a new organization is established, officials of government and our Office discuss the appropriate accounting treatment for it. The main issue is almost always whether the financial results of such organizations should be included (consolidated) within government's Summary Financial Plans and Summary Financial Statements. When they are consolidated, Ministers of government are directly accountable to the Legislative Assembly for the performance of these organizations.

Government Reporting Entity Issues

In recent years, government has created a number of organizations that fall both within and outside the reporting entity. Usually, we agree with government officials on the most appropriate accounting approach. For instance, when the BC Safety Authority and the Land Title and Survey Authority were created, we agreed that these authorities should report their financial results separately from government. Accordingly, their results are not consolidated within government's financial plans or the Summary Financial Statements.

Often, much analysis and discussion takes place before we reach a position on the matter. When the new BC Ferry Services Inc. was created, for example, determining the most appropriate accounting treatment took several months of analysis and discussion. Eventually we adopted a position that, for that point in time, the most appropriate accounting for the organization was to report its financial results separately from government.

For BC Ferry Services Inc., we also undertook to monitor and assess whether that accounting treatment continues to be appropriate. We are doing this because the legislation creating BC Ferry Services established a complex ownership and governance structure, and because the organization has a significant ongoing relationship with government through the Coastal Ferry Services Contract.

There are times when, even after much analysis and discussion, government and our Office do not agree on the most appropriate accounting treatment for a new organization. For example, we disagree with the method used by government to account for the BC Forest Revitalization Trust Account. We think the financial results of this account should be consolidated within government's Summary Financial Statements because the account is not able to make key strategic and operating decisions independent of government.

We also disagree in the case of the British Columbia Investment Management Corporation. We believe that it should be part of the reporting entity because government owns the single share of the corporation. Government, meanwhile, believes that it should be outside the reporting entity because, despite owning the single share, it does not have the ability to appoint a majority of the board.

In both these cases, however, we have determined that the impact of not consolidating either organization is currently not material enough to qualify our opinion on the Summary Financial Statements.

In our report on the 2004/05 Public Accounts,[21] we discussed a number of significant new entities that were created by government and deemed to be outside the government reporting entity. They included:

- Northern Development Initiative Trust
- North Island-Coast Development Initiative Trust
- Southern Interior Development Initiative Trust

Although we took the position that that these entities are to be reported outside of the government reporting entity for fiscal 2005/06, we will continue to monitor their operations and relationship with government to ensure the current treatment remains appropriate. It may not be until these organizations have been in existence for a few years that the interaction between them and government (or lack of it) enables us to clarify the true nature of the relationship.

We also actively monitor (as does government) changes in accounting standards, especially those that might give additional guidance on how to determine which organizations should be part of the government reporting entity. Examples of other entities government has created but currently deems not to be in the government reporting entity include:

- New Relationship Trust
- B.C. Rail Benefits (First Nations) Trust
- Coast Sustainability Trust
- Motor Dealer Administrative Authority
- F.D.B.C. Film Development Society of British Columbia
- British Columbia Achievement Foundation

Given the significant funding often granted to these organizations—and the pervasive role they play in the lives of British Columbia's citizens—we plan to increase our audit focus to examine government's relationship with some of these bodies in more detail to verify their status as independent from government.

[21] *Leading the Way: Adopting Best Practices in Financial Reporting 2004/2005* Report 9, March 2006.

Recommendations Related to Improved Presentation and Other Accounting Changes

Government's financial statement discussion and analysis

Recommendation 1

We continue to recommend that government present a long-term trend analysis in the financial statement discussion and analysis (FSD&A) so that it can provide more context for discussing government's financial performance. In addition, we recommend that government cross-reference the FSD&A and the Financial and Economic Review.

Recommendation 2

We recommend that government continue to expand its financial statement discussion and analysis (FSD&A) to better cover material financial risks and uncertainties and the challenges involved in their ongoing management.

Recommendation 3

We recommend that government adopt the use of the CICA-recommended measure of "government-to-government transfers to own-source revenue" for use in the financial statement discussion and analysis.

Disclosure of contractual obligations

Recommendation 4

We recommend that government disclose contractual obligations for operating expenditures and capital expenditures separately on a comparative basis, and include a summary description of the nature of the expenditures.

Disclosure around the use of estimates

Recommendation 5

We recommend that government disclose the financial statement lines where the items subject to measurement uncertainty are recorded.

Recommendation 6

We recommend that government disclose details of significant changes in prior year accounting estimates.

Disclosure of university-controlled organizations (and any other organizations) that meet the definition of a government business enterprise

Recommendation 7

We recommend that, as required by PSAB standards, the university-controlled organizations (and any other organizations) that meet the definition of a government business enterprise and are accounted for on the modified equity basis be disclosed in the government's financial statements—in the Statement of Financial Position for Self-supported Crown Corporations and Agencies and the Summary of Results of Operations and Statement of Equity for Self-supported Crown Corporations and Agencies.

Recommendations Related to New Issues

Disclosure of tangible capital assets under lease

Recommendation 8

We recommend that government create a table for tangible capital assets under lease, similar to the table presentation used for the current statement of tangible capital assets.

Recommendation 9

We recommend that capital lease related liabilities be disclosed separately to meet PSAB standards on leased tangible capital assets.

Assessment of long-term liabilities and disclosure of material errors

Recommendation 10

We recommend that government regularly assess long-term liabilities to ensure they are a true and fair reflection based on the most recent information available.

Recommendation 11

We recommend that when government corrects material errors in its financial statements, it also provide a description of the error and the effect of the correction, and that it head the prior period columns on the face of the financial statements "as restated."

Recommendations Related to Prior Year Issues

Accounting for resource roads

Recommendation 12

We recommend that government complete its assessment of accounting for resource roads in fiscal 2007/08 and record the applicable roads as tangible capital assets in the Summary Financial Statements.

Recommendation 13

We recommend that government assess where asset retirement obligations should be recorded for applicable resource roads and recognize those obligations in their financial statements.

Retirement and post-employment benefits disclosure

Recommendation 14

We recommend that government fully implement the remaining PSAB standards on retirement benefits to meet the minimum required disclosure.

Recommendation 15

We recommend that government fully implement the PSAB standard on post-employment benefits to meet the minimum required disclosure.

Interest expense disclosure

Recommendation 16

We recommend that government include all interest in a single line item on the financial statements.

Summary of Recommendations

Disclosure of Olympic Games commitments

Recommendation 17

We recommend that government disclose its complete Games-related commitments in its Olympics commitment note.

Policy on interest capitalization

Recommendation 18

We recommend that government revise its policy on capitalization of interest during construction so that the policy is applied more logically (in terms of calculating the amount).

Recommendation 19

We also recommend that government apply its policy on capitalization of interest during construction consistently across the government reporting entity.

Recommendations Related to Changing Standards and Emerging Issues

Segment disclosures

Recommendation 20

We recommend that, in addition to implementing the required segmented reporting standards, government continue its leading practise in this area of disclosure by producing detailed sector schedules in the Summary Financial Statements.

Accounting for treaty accommodation costs

Recommendation 21

We recommend that the Province review accounting for treaty accommodation and settlement costs to ensure transactions are recorded and disclosed in a true, fair and consistent manner.

Response from the Ministry of Finance

Response from the Ministry of Finance

General Comments

We appreciate the opportunity to respond to the Office of the Auditor General's comments. We continue to report our financial statements in accordance with generally accepted accounting principles (GAAP) for senior governments in Canada, and have once again received an unqualified audit opinion for the 2006/07 fiscal year having not only met those requirements, but in many cases exceeded them in the interests of transparency and accountability. An unqualified audit opinion means that the province has reported its financial position and results of operations fairly and in accordance with GAAP. We thank the Auditor General for the suggestions provided.

Over the past year we have worked closely with the government financial reporting community, both nationally and internationally, to promote the development of best practices in public sector reporting. Although we fully meet the requirements of GAAP for senior governments as established by the Public Sector Accounting Board (PSAB), we recognize that there are opportunities to go beyond GAAP to expand disclosure in areas that will improve transparency and accountability. The Office of the Auditor General provides one important perspective as we examine the options for future improvement.

The report of the Auditor General has made several recommendations which highlight potential changes to our current financial statements, as well as areas that will need to be reviewed in the future in response to evolving accounting standards. We agree that all of these areas are important and are committed to thorough analysis of the issue to ensure we adopt the best practices for public sector reporting in the context of governments in Canada. In examining potential changes, we remain conscious that the benefits to users of our financial statements must outweigh the additional costs of providing information and must not impair the timeliness of the release of the Public Accounts.

Ministry Response

Over the past year, we have continued to improve public sector reporting in British Columbia. One positive achievement has been the implementation of a better model for determining the capital and operating elements of complex Public Private Partnerships which the Auditor General has commented on favourably in his report. While the total cost of P3 arrangements remains the same, the new approach allows us to determine the different elements with greater accuracy. We also note that as a result of consistent improvements in the Financial Statement Discussion & Analysis, the Office of the Auditor General feels that it is no longer necessary to produce the annual Monitoring Government Finances report.

Following are responses to the specific recommendations of the Auditor General:

Recommendation 1. In accordance with our original implementation plan, we will be including five years of trend information in the Financial Statement Discussion & Analysis for the 2007/08 Public Accounts. We also agree that a link to the Financial and Economic Review would be beneficial to users of our financial statements.

Recommendation 2. We expanded discussion of material financial risks in the 2006/07 Public Accounts and will continue to examine opportunities for expanding that discussion with information that is meaningful to users.

Recommendation 3. We continue to use the related indicator, Government-to-Government Transfers to Total Revenue, because we believe it is more readily understandable by users of our financial statements and provides the best representation of the province's relative reliance on federal transfers.

Recommendation 4. We currently fulfill the requirements of GAAP in disclosing contractual obligations in our financial statements.

Contractual obligations are estimates of future payments under agreements which may include capital or operating elements or in some cases, both. Because the disclosure is of future payment obligations rather than future expense recognition, we believe it would be inconsistent with the way all other information in the financial statements is presented to represent them as separate capital and operating obligations.

The Auditor General also recommends additional narrative on the nature of specific obligations. Given the highly aggregated nature of the Summary Financial Statements, it would not be possible to provide interested users with sufficient information on the broad range of obligations across the Government Reporting Entity. Interested parties would be better served by examining the detailed disclosure in the financial statements of the crown agencies reporting the obligations.

Recommendation 5. We agree that relating disclosed measurement uncertainty to financial statement lines would be useful information for users of our financial statements and will adopt the recommendation for the 2007/08 Public Accounts.

Recommendation 6. GAAP currently does not provide much guidance on when changes in estimates should be disclosed or in which note the disclosure should be made. We believe there is an opportunity to provide useful information in this area and will work with standards setters and other jurisdictions to examine options.

Recommendation 7. We do not agree that a crown agency's equity investment in non-core subsidiaries should be considered the same as a significant self-supported operation of government which is delegated the responsibility and autonomy to operate as a Government Business Enterprise. We do, however, agree that should any of these arrangements become significant enough to have a material impact on the Summary Financial Statements, we would ensure adequate disclosure of the operations consistent with the disclosure for entities consolidated on the modified equity basis.

Recommendations 8 & 9. Leased capital assets totaled $371 million in the 2006/07 Public Accounts, included with tangible capital assets totalling $29 billion. We disclose this amount in a footnote to the table and do not believe the amounts are material enough to warrant separate detailed disclosure given the highly aggregated nature of the Summary Financial Statements. Also, the amount of future obligations under lease arrangements, the main component of additional lease disclosure, is already included under Contractual Obligations.

Recommendations 10 & 11. We agree that all liabilities should be reviewed and assessed annually as part of the financial reporting process.

The adjustment noted in the report was specifically disclosed in Note 24, footnote 3, on page 60 of the 2006/07 Public Accounts. We do not specifically notate columns "as restated" in the public accounts because the government reporting entity is very large and there are always adjustments to prior year amounts. Instead, we provide disclosure of changes to comparative figures in Note 33 on page 67 of the 2006/07 Public Accounts.

Recommendations 12 & 13. Analysis supporting the capitalization of resource roads began in the 2006/07 fiscal year and continued in 2007/08. We have continued to work with ministries and the Office of the Auditor General to ensure that those roads that meet the criteria of tangible capital assets, and any related retirement obligations, are appropriately capitalized and amortized over their useful life, rather than recognized as expense when built.

Recommendations 14 & 15. We do not agree that additional technical detail is useful in relation to the provinces disclosure of retirement benefits and post employment benefits. Although GAAP does provide an extensive list of information that should be disclosed, it also provides the following direction:

> *"The level of detail disclosed by governments would reflect the highly aggregated nature of summary financial statements. In deciding the level of detail to disclose, governments would consider the usefulness of the information to the reader in assessing the nature of, and the costs associated with, a government's retirement benefits plan. The level of disclosure would also consider the sensitivity of the information in relation to government's financial position."* PS3250.089

We believe that the detailed disclosure already provided in the public accounts, along with the detailed information available through the link to the Pension Corporation in the notes to the financial statements, provides users with sufficient information to satisfy their requirements.

Recommendation 16. We agree that all interest expense should be reported on a single line item. Interest on capital leases, recorded as "Other" expenses, was approximately $7 million in the 2006/07 Public Accounts and will be included with interest expense in the 2007/08 Public Accounts.

Recommendation 17. We do not agree that separate disclosure of indirect spending initiatives related to the 2010 Olympic Games is appropriate in the general purpose financial statements of the province. We believe that specific reports, such as the reports of the Auditor General and the reports of the Vancouver Organizing Committee, are a more appropriate forum for detailed reporting of the games initiative. More information is available in the Auditor General's report on the 2010 Olympic Games and government's response to that report.

Recommendations 18 & 19. We have reviewed the province's policy on capitalization of interest during construction and believe that improvements can be made by refining the policy. We will continue to work on this issue over the next year.

Recommendation 20. The province has for several years provided segmented financial information, even before it was recommended by GAAP. We do not believe that fully segmenting all of the schedules and notes on a sectoral basis would be consistent with GAAP because it would undermine the summary focus of the financial statements.

Recommendation 21. We continually examine the accounting policies of the province to ensure they are consistent with the evolving requirements of GAAP and consistent with emerging best practice for public sector financial reporting in Canada. We have over the past year engaged the financial reporting community nationally and internationally, as well as the Office of the Auditor General, to ensure our treatment of financial transactions arising from treaty settlements is consistent with GAAP.

We believe that the 2006/07 Public Accounts once again demonstrates our commitment to transparent and accountable financial reporting and meets the information needs of our users. We thank the Office of the Auditor General for its continuing support in meeting this objective.